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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE OF THE NATIONAL REALTY COMMITTEE ON BEHALF OF PETITIONER

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INDEX

	PAGE
Authorities Cited	i
Interest of the Amicus	1
The Decision Below	3
Summary of Argument	3
Argument:	
Bargained-For Business Relationships Between Owner-Lessors and Lessees Should Not Be Disturbed	4
(a) Net Lease Provisions	4
(b) Reasonable Rentals	6
(c) Options to Purchase At Fair Market Value	6
(d) The Investment Credit	8
(e) Absence of Cash Flow	8
(f) The Ground Lease	9
Conclusion	12

Authorities Cited

Cases:

Arkansas Bank and Trust Co. v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963)	6
Athenaise M. Hill, 63 T.C. 225 (1974)	8

PAGE

Benton v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) 5
Breece Veneer & Panel Co. v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956) 5, 6, 7

Commissioner v. *Brown*, 380 U.S. 563 (1965) 5, 8

David F. Bolger, 59 T.C. 760 (1973) (*Acq.*) 8

Glynn W. Keeling, 30 CCH T.C.M. 954 (1971) 7

Kearney & Trecker Corp. v. *United States*, 195 F. Supp. 158 (E.D. Wis. 1961) 6
Kitchin v. *Commissioner*, 353 F.2d 13 (4th Cir. 1965) (*en banc*) 6

Lockhart Leasing Co., 54 T.C. 301 (1970), *aff'd*, 446 F.2d 269 (10th Cir. 1971) 7
LTV Corp., 63 T.C. 39 (1974) 6, 7

Manuel D. Mayerson, 47 T.C. 340 (1966) (*Acq.*) 8

Norman Baker Smith, 51 T.C. 429 (1968) 6, 7
Northwest Acceptance Corp., 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974) 6, 7

Reade Manufacturing Co., 32 CCH T.C.M. 1225 (1973) 6

Weiss v. *Weiner*, 279 U.S. 333 (1929) 9

Statute:

Section 48(d) of the Internal Revenue Code of 1954, as amended 8

PAGE

Treasury Regulations:

Treas. Reg. §1.48-4 8
Treas. Reg. §1.162-11(b)(1) 9
Treas. Reg. §1.178-1 9

Revenue Ruling:

Rev. Rul. 61-217, 1961-2 C.B. 49 9

Revenue Procedures:

Rev. Proc. 62-21, 1962-2 C.B. 418 9
Rev. Proc. 72-10, 1972-1 C.B. 721 9

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Interest of the Amicus

The National Realty Committee is a non-profit business league of real estate owners, builders, developers and investors with approximately 250 members throughout the United States. Its membership includes some of the largest and most important real estate firms in the industry. As part of its program of representing the real estate industry, it regularly monitors and responds to proposed changes in federal tax legislation affecting the industry and, on ap-

propriate occasions, presents the views of its members to the judicial, legislative and executive branches of government.

Deductions for income tax purposes of depreciation and interest are major economic incentives to real estate investment for a significant segment of the real estate industry. The decision of the court below disallows deductions traditionally enjoyed by owners of real property arising out of commercial arrangements negotiated at arm's length. The decision thus raises a doubt concerning the tax attributes of ownership of property held under long-term leases. This doubt is sufficient to impair the value and marketability of affected real estate. Since real estate investment requires substantial capital outlays, investors will be unwilling to invest when there is uncertainty concerning the tax attributes of the property being acquired.

If the tax deductions heretofore available to real estate owners cease to be available, lessors will require additional rent to compensate for the loss of economic benefits attributable to such deductions. Increases in rent will inevitably increase the cost of doing business, stimulate inflation and discourage business expansion.

The National Realty Committee believes that predictability of tax consequences of leasing arrangements is of major importance to the real estate industry and that the manner in which the instant case is decided will have an important impact on the growth and stability of a significant portion of the industry.

The Decision Below

The court below, reversing the District Court, held that a sale by Worthen Bank & Trust Company ("Worthen"), of a building (the "Property") to Frank Lyon Company ("Taxpayer"), followed by a long-term leaseback of the Property, constituted a loan and not a sale and lease. The court below held further that since the Taxpayer did not become the owner of the Property for federal income tax purposes, it was not entitled to deductions for depreciation and interest with respect to the Property. By so doing, the court below altered the economic benefits of the ownership of property bargained for in arm's length negotiations.

Summary of Argument

The tax attributes of ownership of property are economic rights. The allocation of those rights when they reflect common commercial practice and are derived from agreements negotiated at arm's length should not be disturbed unless there is an overriding policy consideration which would warrant such action. The decision of the court below suggests no such overriding policy. To shift the tax attributes of ownership in this case will disrupt the bargained-for economic arrangements, resulting in a loss to Taxpayer and a windfall to Worthen. If the decision of the court below is allowed to stand, there may be a severe disruption of the economic relationships between lessors and lessees under long-term leases.

ARGUMENT

Bargained-For Business Relationships Between Owner-Lessors and Lessees Should Not Be Disturbed.

The court below held that the sale and leaseback entered into by Taxpayer and Worthen, bargained for at arm's length, should be characterized as a loan. This conclusion was based in large part on provisions in the lease which are common in lessor-lessee relationships: "net" rent at reasonable rates; options to purchase for amounts the parties estimated to be fair market value; and allocation of the investment credit to the lessee. The court below also relied on the absence of annual cash flow and the fact that Taxpayer leased the underlying land from Worthen. The District Court found that none of these factors were indicia of ownership by Worthen. Examining these factors in their business context reveals that they are based on sound business considerations in the lessor-lessee relationship and their presence in a sale and leaseback should not be grounds for rearranging the normal tax consequences of the lessor-lessee relationship.

(a) *Net Lease Provisions.*

There is no economic difference between a gross lease and a net lease. In a gross lease, fixed rentals are determined by including in the gross rent the projected expenses with respect to the leased property, such as utilities, insurance and real estate taxes. Net leases, on the other hand, provide for lower fixed rents, but require the lessee to pay operating expenses directly. In both cases,

the lessee pays for such costs, either directly or indirectly. It is common for gross leases to have escalation clauses providing for increased rents tied to increased costs so that the net rent received by an owner-lessor will not decrease. Owners generally are unwilling to assume open-ended obligations to pay for increased costs over a long period. With net leases the owner is assured of the agreed net return on his investment throughout the lease term.

Net leases characteristically involve a shifting of risk from lessor to lessee. The reliance by the court below on the presence of a net lease to conclude that a bona fide sale and leaseback had not occurred is in direct conflict with *Commissioner* v. *Brown*, 380 U.S. 563 (1965), where this Court specifically rejected the argument, in a sale and leaseback transaction, that the absence of risk shifting affected the bona fides of the transaction. The District Court, consistently with *Brown*, correctly attributed no significance to the presence of a net lease:

> The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases.

Appendix to Certiorari Petition ("Cert. Pet. Appx.") at 12a. In so doing, the District Court reached the same result as have many other courts. *See, e.g., Breece Veneer & Panel Co.* v. *Commissioner*, 232 F.2d 319, 320 (7th Cir. 1956); *Benton* v. *Commissioner*, 197 F.2d 745, 748 (5th Cir.

1952); *Arkansas Bank and Trust Co.* v. *United States,* 224 F. Supp. 171, 174 (W.D. Ark. 1963); *Kearney & Trecker Corp.* v. *United States,* 195 F. Supp. 158, 161 (E.D. Wis. 1961); *LTV Corp.,* 63 T.C. 39, 49-50 (1974); *Northwest Acceptance Corp.,* 58 T.C. 836, 839 (1972), *aff'd,* 500 F.2d 1222 (9th Cir. 1974); *Norman Baker Smith,* 51 T.C. 429, 432 (1968); *Reade Manufacturing Co.,* 32 CCH T.C.M. 1225, 1229-30 (1973).

(b) *Reasonable Rentals.*

Where rents have been reasonable the courts have found true lessor-lessee relationships. *Kitchin* v. *Commissioner,* 353 F.2d 13, 15 (4th Cir. 1965) (*en banc*); *Breece Veneer & Panel Co., supra,* 232 F.2d at 322. Reasonable rent cannot be determined solely on the basis of a comparative analysis of costs per square foot in a given area. Rent depends upon a variety of factors including, among others, the ability of the lessor to finance on the basis of the quality of the lessee, the terms of the lease and the intrinsic value of the property. These factors affect rent because they affect the lessor's borrowing costs.

When a seller leases back the conveyed property, if the rents are reasonable, the purchaser-lessor can take advantage of a variance in interest rates to refinance his cost of acquisition and dramatically increase his annual cash flow from the property.

(c) *Options to Purchase at Fair Market Value.*

It is not uncommon for owners to grant lessees options to purchase leased property. Lessees seek such options, for example, because particular properties through a long course of business dealings in a community establish values to such lessees over and above the intrinsic

value of the real estate. Thus, a lessee may wish to purchase a property to preserve the good will established in a particular locality. If the option price is at fair market value, the owner will receive the full value of his property.

An option to purchase at a price estimated, at the time the lease is made, to be fair market value when it is to be exercised (in contrast to a price estimated to be nominal at that time) has been held to be indicative of ownership by the lessor, and not the lessee. *See, e.g., LTV Corp., supra,* 63 T.C. at 50.

Similarly, a fixed substantial option price even if it is less than fair market value is also consistent with lessor ownership since it is not certain that the option will be exercised. *See Breece Veneer & Panel Co., supra,* 232 F.2d at 322; *Northwest Acceptance Corp., supra,* 58 T.C. at 847-48; *Lockhart Leasing Co.,* 54 T.C. 301, 314 (1970), *aff'd,* 446 F.2d 269 (10th Cir. 1971); *Norman Baker Smith, supra,* 51 T.C. at 439; *Glynn W. Keeling,* 30 CCH T.C.M. 954, 959 (1971). The option price is often determined by the relative bargaining strengths of the parties; it is not indicative of a financing unless it is so nominal that the lessee is economically "compelled" to exercise.

Here, the District Court found as a fact that the option price "represent[ed] the negotiated estimate of [the parties] as to the fair market value of the building on the option dates", and that such estimate was "reasonable". Cert. Pet. Appx. at 6a. Although an unrealistically low option price indicates economic compulsion of reacquisition by the lessee, no such compulsion exists when the option price approximates fair market value. Under these

circumstances, the court below erred in relying on the options to purchase in reaching its decision.

(d) *The Investment Credit.*

The court below, without explanation, considered relevant the fact that Worthen retained the investment credit stemming from the construction of the Property. However, since section 48(d) of the Internal Revenue Code of 1954, as amended, (the "Code"), and Treasury Regulation §1.48-4, expressly authorize a lessor to assign the investment credit to its lessee, this factor can in no way be relevant to the question whether the transaction is a sale and leaseback or a loan.

(e) *Absence of Cash Flow.*

The court below noted that during the initial 25-year term of the lease the rents received exactly equalled the payments necessary to satisfy debt service on the mortgage. This reflects nothing more than the extent to which the purchase of the building was financed and was not indicative of a debtor-creditor relationship between the Taxpayer and Worthen. *See Brown, supra. Cf. Manuel D. Mayerson,* 47 T.C. 340 (1966) (*Acq.*).

In this regard the language of the court in *Athenaise M. Hill,* 63 T.C. 225, 243 (1974), is apposite:

> [W]hile there would be no positive cash flow from the property [for twenty years] the [taxpayers] could foresee over such period, the gradual buildup in their equity in a valuable piece of property . . . .

Here, Taxpayer will own the Property unencumbered after the initial 25-year lease term. *See also David F. Bolger,* 59 T.C. 760 (1973) (*Acq.*).

Furthermore, Taxpayer, not Worthen, has the right to satisfy or refinance the indebtedness. The right to refinance allows Taxpayer to obtain the benefit of a decline in interest rates, either by an immediate cash return or by increased cash flow from the reduction in debt service.

(f) *The Ground Lease.*

One of the most common divisions of interests in property is that between ground lessor and ground lessee. As this Court has recognized in *Weiss* v. *Weiner,* 279 U.S. 333 (1929), and the Commissioner has recognized in Rev. Rul. 61-217, 1961-2 C.B. 49, as between lessor and lessee, the party with the monetary investment in an improvement has the right to depreciate it. The Treasury has specifically recognized that if a lessee constructs improvements on leased land, it is the lessee, not the lessor, who is entitled to depreciate the improvements. Treas. Reg. §1.162-11(b)(1); Treas. Reg. §1.178-1.

The Commissioner in Rev. Rul. 61-217, *supra,* ruled that where a lessee of land constructs improvements on the land and sells those improvements to a third party, the purchaser, *not* the landowner, is entitled to depreciate those improvements. Therefore, the fact that Worthen continued to own the land after selling the improvements to Taxpayer has no relevance to a determination of which party is entitled to depreciate the Property.

Further, it is highly unlikely that Worthen will acquire the existing building at the end of the 76-year ground lease term. In both Rev. Proc. 62-21, 1962-2 C.B. 418, 420 and Rev. Proc. 72-10, 1972-1 C.B. 721, 731, the Service suggested a 45-year useful life for office buildings. Thus, it

is highly probable that the economic life of the building will be exhausted during the ground lease term. Taxpayer, therefore, will bear the burden of depreciation of the building. Accordingly, the reliance of the court below on the existence of the ground lease was misplaced.

If the foregoing factors were permitted to serve as a basis for treating lessees as owners of real property, many existing economic arrangements which were the result of bargains between owners and lessees will be altered. Lessees will reap an after-tax windfall by being entitled to deductions with respect to property owned by their lessors, and lessors will suffer a significant reduction in economic benefits to be derived from their property. The values of the properties affected will fall. This is particularly so with respect to properties with long-term leases. A long-term reduction of benefits to be derived from a particular parcel of realty will necessarily impair values. Such a rearrangement of economic relationships should not be brought about by either administrative or judicial determinations.

The inability of owners of real property to realize benefits heretofore anticipated from such ownership will also impede the acquisition and development of real estate, unless compensatory benefits are provided by way of additional rent. Since increased rent will inevitably increase the cost of doing business, it will serve to discourage a significant number of business enterprises.

Nowhere has it been or could it be shown that these consequences were contemplated by Congress. They should

not be imposed on the real estate industry in particular, and business in general, either by the Commissioner or by judicial fiat, unless an overriding public policy justifies such action. No such public policy has been demonstrated.

The real estate industry is a capital intensive industry which historically has required reasonable opportunities for capital cost recovery in order to attract necessary capital. The Code provides for this principally through provisions permitting an owner of improved real property to recover its cost through deductions for depreciation over the useful life of the improvements.

CONCLUSION

Tax consequences are an intrinsic element of the economics of all business transactions. Therefore, predictability of tax consequences in traditional relationships between lessors and lessees is of major importance to the real estate industry and to business development in general. The decision of the court below, since it disrupts economic consequences of relationships arrived at as the result of arm's length bargaining, should be reversed.

Respectfully submitted,

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